

***United States Court of Appeals  
for the Second Circuit***



**APPELLANT'S  
BRIEF**





Original

77-6091

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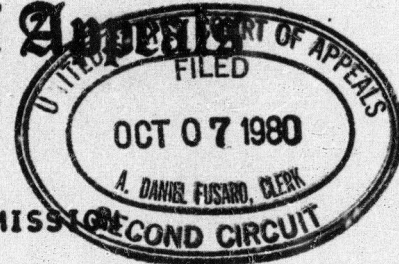
77-6091

Bpls.

To be submitted by  
BARRY M. FALICK

**United States Court Of Appeals**

For the Second Circuit



SECURITIES AND EXCHANGE COMMISSION

Plaintiff-Appellee,

against

E.L. AARON & CO., INC.,

Defendants,

PETER E. AARON,

Defendant-Appellant

ON REMAND FROM AN ORDER OF  
THE UNITED STATES SUPREME COURT

**SUPPLEMENTAL BRIEF OF DEFENDANT-APPELLANT**

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Of Counsel



UNITED STATES COURT OF APPEALS  
FOR THE SECOND CIRCUIT

~~XXXXXX~~

77-6091

SECURITIES AND EXCHANGE COMMISSION,  
Plaintiff-Appellee, ~~XXXXX~~

against

E.L. AARON & CO., INC., et al.,  
Defendants,

PETER E. AARON,  
Defendant-Appellant. ~~XXXXXX~~

AFFIDAVIT OF SERVICE  
BY MAIL

STATE OF NEW YORK, COUNTY OF NEW YORK

ss.:

*The undersigned being duly sworn, deposes and says:*

*Deponent is not a party to the action, is over 18 years of age and resides ~~XX~~ in Brooklyn, New York.*

*That on* October 7, 19 80 *deponent served the annexed*  
*SUPPLEMENTAL BRIEF*  
*RALPH C. FERRARA*  
*on*  
*attorney(s) for* Plaintiff-Appellee  
*in this action at* SECURITIES AND EXCHANGE COMMISSION, WASHINGTON, D.C. 20549  
*the address designated by said attorney(s) for that purpose by depositing a true copy of same enclosed*  
*in a postpaid properly addressed wrapper, in—a post office—official depository under the exclusive care*  
*and custody of the United States Postal Service within the State of New York.*

*Sworn to before me this*

*7th day of October, 1980.*

*Dolores Vasquez*

The name signed must be printed beneath

DOLORES VASQUEZ

*[Signature]*  
KENNETH PLATZER  
Notary Public, State of New York  
No. 9822587  
Qualified in New York County  
My Commission Expires Mar. 30, 1982

Index No.

against

Plaintiff

Defendant

**ATTORNEY'S  
AFFIRMATION OF SERVICE  
BY MAIL**

**STATE OF NEW YORK, COUNTY OF**

**ss.:**

*The undersigned, attorney at law of the State of New York affirms: that deponent is  
attorney(s) of record for*

*That on*

*19*

*deponent served the annexed*

*on  
attorney(s) for  
in this action at*

*the address designated by said attorney(s) for that purpose by depositing a true copy of same enclosed  
in a postpaid properly addressed wrapper, in—a post office—official depository under the exclusive care  
and custody of the United States Postal Service within the State of New York.*

*The undersigned affirms the foregoing statement to be true under the penalties of perjury.*

*Dated*

.....  
The name signed must be printed beneath

*Attorney at Law*



77-6091

To be submitted by  
BARRY M. FALLICK

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UNITED STATES COURT OF APPEALS  
For the Second Circuit

SECURITIES AND EXCHANGE COMMISSION,

Plaintiff-Appellee,

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E.L. AARON & CO., INC., et al.,

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PETER E. AARON,

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ON REMAND FROM AN ORDER OF  
THE UNITED STATES SUPREME COURT

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SUPPLEMENTAL BRIEF OF DEFENDANT-APPELLANT

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UNITED STATES COURT OF APPEALS  
FOR THE SECOND CIRCUIT

-----X  
SECURITIES AND EXCHANGE COMMISSION,

Plaintiff-Appellee,

-against-

Docket No.  
77-6091

E.L. AARON & CO., INC., et al.,

Defendants.

PETER E. AARON,

Defendant-Appellant.  
-----X

ISSUES PRESENTED FOR REVIEW

1. What level of scienter is required in civil enforcement actions, and whether on the facts presented in this record, Aaron's conduct in failing to terminate misleading statements made by two employees of E.L. AARON & CO., INC., knowing them to be fraudulent, satisfies that scienter standard?

2. Whether, in light of the Supreme Court's holding in Aaron v. S.E.C. —U.S.— (June 2, 1980), the District Court abused its discretion in issuing a permanent injunction?



### PRELIMINARY STATEMENT

This supplemental brief discusses questions with respect to the level of scienter necessary in a civil enforcement action, and whether appellant's conduct satisfies that standard. In addition, this brief presents a question with respect to whether the District Court abused its discretion in enjoining the appellant from future violation of the Federal Securities Laws.

The Securities and Exchange Commission brought this action for preliminary and final injunctive relief pursuant to Section 20(b) of the 1933 Act, 15 U.S.C. §77t(b) (1976), and Section 21(d) of the 1934 Act, 15 U.S.C. §78u(d) (a) (1976). The complaint filed on February 26, 1976 charged Aaron and three other defendants with violating and aiding and abetting violations of the registration provisions of §§5(a) and 5(c) of the 1933 Act, 15 U.S.C. §§77e(a) and 77(e) (c) (1976). The complaint also alleged that Aaron and seven other defendants<sup>1/</sup> violated the anti-fraud provisions of both acts, Section 17(a) of the 1933 Act, 15 U.S.C. §77q(a) (1970), Section 10(b) of the 1934 Act, 15 U.S.C. §78j(b) (1970), and of Rule 10b-5 promulgated thereunder, 17 C.F.R. §240.10b-5 (1971), in connection with the offer and sale of common

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<sup>1/</sup> The seven other defendants other than Aaron consented to the entry of permanent injunction against them.



stock of Lawn-A-Mat Chemical & Equipment Corp. Specifically, the complaint alleged that Aaron, who was an employee and assistant to the President of E.L. Aaron & Co., Inc., a broker-dealer registered with the Commission, exercised managerial and supervisory authority over E.L. Aaron & Co., Inc.'s registered representatives. In this connection, it was charged that petitioner, after being informed that employees of the broker-dealer firm were making false and misleading statements in connection with their attempts at selling LAM stock, did nothing to stop the false and misleading misrepresentations from being made by the employees. After a three day evidentiary hearing in the Southern District of New York, the District Court concluded that Aaron had violated the anti-fraud provisions of the 1933 and 1934 Acts and the registration provisions of the 1933 Act.<sup>2/</sup>

In addition, the District Court found that "while Aaron himself did not make any misrepresentations, by failing to stop Schreiber and Jacobson, he willfully aided and abetted their violations of the anti-fraud provisions of the securities laws." Moreover, the District Court also determined that:

"While negligence alone may suffice  
as a standard for liability in

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<sup>2/</sup> The opinion of the District is reported in Fed. Sec. L. Rep. (cch), at §96, 043.



Commission enforcement proceedings,  
the fact that Peter Aaron intentionally  
failed to terminate the false and  
misleading statements made by Schreiber  
and Jacobson, knowing them to be  
fraudulent, is sufficient to establish  
his scienter under the securities laws."

(Citations omitted.)

As to the remedy, even though the firm had since gone bankrupt and the petitioner was no longer working for a broker-dealer, the District Court reasoned that injunctive relief was warranted in light of "the nature and extent of the violations . . . , the [petitioner's] failure to recognize the wrongful nature of his conduct and the likelihood of the [petitioner] repeating his violative conduct."

The Court of Appeals for the Second Circuit affirmed the judgment. SEC v. Aaron, 605 F.2d 612(1979). This Court also stated: "We find it unnecessary to reach the question whether Aaron's conduct would support a finding of scienter, since we hold that the scienter requirement enunciated in Hochfelder is not applicable to government enforcement actions brought under §§10(b) and 21(d) fo the 1934 Act." Id. at 619.



The Supreme Court "granted certiorari to resolve the conflict in the federal courts as to whether the Commission is required to establish scienter - an intent on the part of the defendant to deceive, manipulate, or defraud - as an element of a Commission enforcement action to enjoin violations of §17(a), §10(b), and Rule 10b-5. 444 U.S. 914." On June 2, 1980, the Supreme Court held "that the Commission is required to establish scienter as an element of a civil enforcement action to enjoin violations of §17(a)(1) of the 1933 Act, §10(b) of the 1934 Act, and Rule 10b-5 promulgated under that section of the 1934 Act. The Court further held that the Commission need not establish scienter as an element of an action to enjoin violations of §17(a)(2) and §17(a)(3) of the 1933 Act . . . "



POINT I

BY FAILING TO SHOW THAT THE  
APPELLANT HAS ACTED WITH  
SCIENTER, THE COMMISSION  
HAS NOT ESTABLISHED VIOLATIONS  
OF THE FEDERAL SECURITIES LAWS.

The issues which must be determined are what level of scienter is required in civil enforcement actions, and whether on the facts presented in this record, Aaron's conduct in failing to terminate misleading statements made by two employees of E.L. Aaron & Co., Inc., knowing them to be fraudulent, satisfies that scienter standard.

In Ernst & Ernst v. Hochfelder, 425 U.S. 185, 194, fn.12(1976), a case involving a private cause of action under section 10(b) of the 1934 Act and Rule 10b-5 promulgated thereunder, the Supreme Court stated:

"In this opinion the term "scienter" refers to a mental state embracing intent to deceive, manipulate, or defraud. In certain areas of the law recklessness is considered to be a form of intentional conduct for purposes of imposing liability for some act. We need not address here the question whether, in some circumstances, reckless behavior is sufficient for civil



liability under §10(b) and Rule 10b-5."

Thereafter, in the present case, Aaron v. SEC, —U.S.—

fn.5 (June 3, 1980), the Supreme Court stated:

"The term "scienter" is used throughout this opinion, as it was in Ernst & Ernst v. Hochfelder, 425 U.S. 185, at 193, n.12, to refer to "a mental state embracing intent to deceive, manipulate, or defraud." We have no occasion here to address the question, reserved in Hochfelder, ibid., whether, under some circumstances, scienter may also include reckless behavior.<sup>3/</sup>

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3/ Since Hochfelder, this Court has held that recklessness satisfies the scienter requirement in a private cause of action under §10(b). Rolf v. Blyth, Eastman Dillon & Co., 570 F.2d 38,44 (2d Cir. 1978), cert. denied, 439 U.S. 1039. In Rolf, this Court stated at P.47: "Reckless conduct is, at the least, conduct which is "highly unreasonable" and which represents "an extreme departure from the standards of ordinary care . . . to the extent that the danger was either known to the defendant or so obvious that the defendant must have been aware of it." Sanders v. John Nuveen & Co., 554 F.2d 790, 793 (7th Cir. 1977).

This Court's holding in Rolf is consistent with its pre-Hochfelder determination. See, e.g., Lanza v. Drexel & Co., 479 F.2d 1277, 1306 (2d Cir. 1973) (en banc); Shemtob v. Shearson Hammill & Co., 448 F.2d 442, 475 (2d Cir. 1971). But see SEC v. Bausch & Lomb 420 F. supp. 122b, 1241 & fn.4 (S.D.N.Y. 1976) aff'd. on other grounds, 565 F.2d 8 (2d Cir. 1977). (Their language, coupled with the Supreme Court's emphasis that scienter means intent to deceive, manipulate, or defraud leads to a conclusion that only what Judge Friendly has characterized as "the kind of recklessness that is equivalent to willful fraud," TGS supra. at 868, will serve as a basis for liability). See also, SEC v. American Realty Trust, 429 F. supp. 1148, 1171 fn. 8 (E.D. Va. 1977) (recklessness does not satisfy Hochfelder)



It appears that a literal examination of the Hochfelder and Aaron opinions suggests that a strict construction of scienter is warranted. Both opinions defined scienter as "a mental state embracing intent to deceive, manipulate, or defraud." The Supreme Court in Hochfelder and Aaron based its conclusion primarily on the "plain meaning of §10(b). Construing the language of Section 10(b), that Court determined that the "words manipulative or deceptive" used in conjunction with device or contrivance strongly suggest that §10(b) was intended to proscribe knowing or intentional misconduct (425 U.S. at 197). Moreover, that Court stressed as "especially significant" the use of the word "manipulation." "It is and was virtually a term of art when used in connection with securities markets. It connoted intentional or willful conduct designed to deceive or defraud investors by controlling or artificially affecting the price of securities." (425 U.S. at 199).

In any event, applying the strict construction standard of scienter as defined in Hochfelder and Aaron, or the standard developed in Rolf, the SEC has failed to prove that the appellant's conduct violated the Federal Securities Laws. Initially, it must be noted that the District Court made no finding that Aaron himself had made any misrepresentations, "(but) by failing to stop Schreiber and Jacobson,



he willfully aided and abetted their violations of the antifraud provisions of the Securities Laws." Moreover, the trial record reveals that on just two separate occasions, several months apart, appellant was made aware that misrepresentations were being made by other employees of E.L. Aaron & Co. In each instance, petitioner telephoned the branch office where those employees worked, informed them of the nature of the complaints, and requested that they discuss the matter with Lawn-A-Mat's attorney.

The failure by appellant to take any other affirmative steps was not due to any purpose on his part to defraud the public; his inaction should not be considered a conscious imposition of unnecessary risk of deception on the public. Rather, his failure to follow through on his telephone calls to Schreiber and Jacobson can only be characterized as carelessness or a result of poor judgment. There can be no doubt that appellant was attempting to act in good faith. If Aaron intended to aid and abett Schreiber and Jacobson in defrauding potential investors, he would not have directed them to communicate with Kean; appellant had to be aware of the fact that Kean would have informed them that the statements they were making were false and misleading. Aaron obviously believed that Schreiber and Jacobson by speaking to Kean and learning that their statements were false and misleading would



discontinue them.

For these reasons, it is apparent that the SEC has failed here to prove that the appellant acted with an intent to deceive or in a reckless fashion in connection with his failure to take adequate steps to prevent Schreiber and Jacobson from continuing to make false and misleading statements.



POINT II

THE DISTRICT COURT ABUSED  
ITS DISCRETION IN ISSUING AN  
INJUNCTION; APPELLANT WAS NOT  
ENGAGED OR ABOUT TO ENGAGE IN  
A SUBSTANTIVE VIOLATION OF  
THE FEDERAL SECURITIES LAWS.

Appellant argues that even if he was properly found to have violated the Securities Laws, it was inappropriate for the Court to have issued an injunction.<sup>4/</sup>

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<sup>4/</sup> The seriousness of permanent injunctions was noted by Mr. Chief Justice Burger in his concurring opinion in Aaron v. SEC, supra; "An injunction is a drastic remedy, not a mild prophylactic, and should not be obtained against one acting in good faith." Moreover, in SEC v. Commonwealth Chemical Securities, Inc., 574 F.2d 90,99 (2d Cir. 1978), Judge Friendly observed that

"[i]t is fair to say that the current judicial attitude toward the issuance of injunctions on the basis of past violations at the SEC's request has become more circumspect than in earlier days. Experience has shown that an injunction while not always a 'drastic remedy' as appellants contend, often is much more than the 'mild prophylactic' described . . . in SEC v. Capital Gains Research Bureau, Inc., 306 F.2d 606,613 (2d Cir. 1962), a phrase quoted by the Supreme Court at 375 U.S. 180, 193, 84 S.Ct. 275, 11 L.Ed. 2d 237 (1963)." "



In Aaron, the Supreme Court denominated the necessary elements that the Commission must prove in seeking injunctive relief under §20(b) of the 1933 Act and §21(a) of the 1934 Act.

"The element of a proper showing thus include, at a minimum, proof that a person is engaged in or is about to engage in a substantive violation of either one of the Acts or of the regulations promulgated thereunder."

Moreover, the Supreme Court also stated:

"In cases where the Commission is seeking to enjoin a person "about to engage in acts or practices which . . . will constitute" a violation of those provisions, the Commission must establish a sufficient evidentiary predicate to show that such future violation may occur. See SEC v. Commonwealth Chemical Co., 574 F.2d 90, 98-100 (CA 1978) (Friendly, J.); III L, Loss, supra, at 1976. An important factor in this regard is the degree of intentional wrongdoing evident in a defendant's past conduct. See SEC v. Wills, 472 F. Supp. 1250, 1273-1275 (DC 1978)."

Clearly, the record here indicates that at the time the injunction was issued, appellant was not engaged in a



substantive violation of either one of the Securities Act, nor was he about to engage in any acts in violation of these provisions. In the instant matter, the complained of actions took place prior to the filing of the complaint, and took place within a short period of time, and there was no evidence of prior or subsequent violations. Moreover, at the time the injunction was issued, E.L. Aaron & Co., had gone bankrupt, and the appellant was no longer working for a broker-dealer. In addition, the District Court determined that Aaron himself had not made any misrepresentations, nor was it shown that appellant expected to profit greatly from the false statements of Schreiber and Jacobson. Accordingly "the Commission has failed to establish a sufficient evidentiary predicate to show that such future violation may occur."



CONCLUSION

For the foregoing reasons, the judgment of the  
District Court should be reversed.

Respectfully submitted,

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